

Business Service Centers in Ukraine

**A Study of the Agency
for the Development
of Enterprise, the L'viv
NewBizNet Business
Service Center, and
the Vinnytsia
Consulting Center**



Widening the circle, moving ahead

MICROENTERPRISE BEST PRACTICES

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Business Service Centers in Ukraine: A Study of the Agency for the Development of Enterprise, the L'viv NewBizNet Business Service Center, and the Vinnytsia Consulting Center

by

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ACRONYMS AND ABBREVIATIONS

ADE	Agency for the Development of Enterprise
BCC	Business Communication Center (EU TACIS)
BDS	business development services
BDSP	business development service provider
BKHF	British Know How Fund
BSC	business service center
DAI	Development Alternatives, Inc.
EBRD	European Bank for Reconstruction and Development
EU	European Union
ICG	International Consulting Group
IFC	International Finance Corporation
IIBD	Institute for International Business Development
JSC	joint stock company
KMK	Kiev Management Konsult
LCG	L'viv Consulting Group
LIM	L'viv Institute of Management
LTD	limited liability company
LTTE	long-term technical expert
L'viv BSC	L'viv NewBizNet Business Service Center
MBP	Microenterprise Best Practices Project
MSME	micro, small, and medium sized enterprise
NewBizNet	DAI's program for the support of small and medium-sized enterprises in Ukraine and Moldova (funded by USAID; see below)
NICO	Northern Ireland Public Sector Enterprises, Ltd.
PCC	project coordination center (NewBizNet Project)
PCV	Peace Corps volunteer
PPC	post privatization center
PPP	Post-Privatization Project (IFC)
PPU	Project Preparation Unit (EU TACIS)
SMG	smart marketing group
TACIS	Technical Assistance to the Commonwealth of Independent States
TOT	training of trainer
UAH	Ukrainian Hryvnia
ULIE	Ukrainian League of Industrialists and Entrepreneurs
USAID	United States Agency for International Development
VCC	Vinnytsia Consulting Center
WESTNIS	Western Newly Independent States Enterprise Fund
WUMC	Western Ukrainian Management Consulting

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CHAPTER ONE INTRODUCTION

TRENDS AND CHALLENGES IN MSME SUPPORT PROGRAMS

Donor strategies for micro, small, and medium-sized enterprise (MSME) development in Ukraine have evolved in two ways: institutional development and commercialization of services. In the first way, initial donor programs have evolved from direct, firm-level assistance to MSMEs to institutional development of business service providers. Donors have sought to stimulate and facilitate growth of the MSME sector by making business development services (BDS)—a mix of training, consulting, and information—more accessible to a wider range of MSMEs across the country. Donor programs have addressed the weak institutional capacity in Ukraine to deliver services by creating new institutions and strengthening existing ones. The institutional development of local business service centers (BSCs) is expected to result in (1) greater access to BDS by the MSME community, at a lower cost than is possible using Western consultants; (2) continuity of service provision; and (3) the integration of business service providers into the business community.

The other donor trend is a move toward a commercial model of BDS delivery in order to create financially viable institutions that will continue to provide services to MSMEs beyond the life of donor funding. The business center model is typically pursued as a public/private partnership, wherein public funds are invested in private and/or publicly managed business centers to provide quality services below commercial rates to MSMEs. Public subsidies are intended to stimulate business growth while also generating a positive return on the subsidies invested in the centers.¹ This model, however, depends on the availability of public funds and their allocation in support of the MSME sector. In the short to medium term, the Ukrainian government is not in a position to subsidize BDS as is typical in more developed economies. Therefore, BSCs must rely more heavily on fee generation to reach sustainability. Yet, the commercialization approach represents uncharted territory and brings its own set of problems and issues, including:

- How to reconcile Western business practices with local methods, customs, and practices.
- How to reconcile the often competing goals of service outreach and sustainability to a specific target group (MSMEs) and the long-term financial viability of fee-based business service centers.
- How to intervene with the right mix of subsidies and incentives to strengthen rather than distort market signals for MSME support services.

¹ “The Economic Impact of Small Business Development Center Consulting Activities in the United States: 1992-1993,” James J. Chrisman. This study reported that the benefits and costs of U.S. government-supported Small Business Development Centers show that the consulting activities of the 47 centers in the study generate approximately \$2.12 in tax revenues for every \$1.00 spent.

The challenge for donors and practitioners is to provide BDS in markets where the potential of public support through subsidies is weak, while providing the right incentives to address the needs of MSMEs that are least able to pay.

MICROENTERPRISE BEST PRACTICES RESEARCH INTERESTS

The Microenterprise Best Practices (MBP) Project is interested in learning about the process of commercializing business development services. The trends and challenges faced in Europe and the Newly Independent States of the former Soviet-Union region mirror a general rethinking in the field that entails moving from supply-led to demand-led and market-based approaches to BDS delivery. The MBP Project chose to undertake this research in Ukraine for three reasons:

1. Donor involvement in the MSME sector is active and expanding.²
2. A strong push exists to use market-based strategies and to commercialize business support institutions.
3. There exists an evolving market (with a strong donor presence) that is becoming more dynamic as reforms take hold.

RESEARCH DESIGN: OBJECTIVE AND METHODS USED

Objective

The objective of this research is to draw lessons from the process and early results of commercialization of BDS from a limited sample of donor-supported BSCs, their clients, and direct private-sector competitors operating in the markets of the donor-assisted centers. The findings from the research will contribute to a better understanding of the design and implementation of market-based BDS programs in support of MSMEs in developing and emerging economic settings.

Research Design and Its Evolution

The research examines the operations of three donor-supported BSCs and direct commercial competitors in their markets. The donor-funded business service centers studied for this research are:

² For the purpose of this study, the term “MSME” is used as defined in the *USAID Strategy for SME Development in Ukraine*: a broad range of enterprises, from sole proprietorships to businesses that employ up to 250 workers. (EU TACIS in Ukraine defines a small business as having 1 to 50 workers, and a medium-sized business as having 500 to 5,000 workers.)

- The Agency for the Development of Enterprise (ADE), located in the capital of Kiev (pop. 2.5 million), is a nonprofit joint stock company established in 1993 with support from the European Union.
- L’viv NewBizNet BSC (L’viv BSC), located in the western region (pop. 850,000), is a for-profit unit of the L’viv Institute of Management started in 1990 and funded by the U.S. Agency for International Development (USAID) through a contract with Development Alternatives, Inc.
- Vinnytsia Consulting Center (VCC), located in the central region (pop. 375,000), was established in 1997 and funded by USAID through an agreement with the International Finance Corporation (IFC).³

The centers have different origins, operate in markets of differing sizes and sophistication, and have operated over different time frames, yet they are combined in one research activity for two reasons: each provider is driven by the common goal of achieving financial viability, and each uses a core strategy of building fee-paying markets for their services.

The research team spent five weeks in four locations and interviewed 110 people to get a better understanding of the above business process from those closest to it: business center managers, staff, consultants, their customers, and their competitors. Expatriate advisors and USAID NewBizNet Project project coordination center staff were also interviewed. The findings in this study, however, are based primarily on reports of those directly involved with the provision of BDS. (In many cases, the current expatriate advisors were not the ones who initiated the BSC projects.)

Original Learning Framework

The learning objective was to gain a better understanding of **how BDS providers have managed** the process of commercializing business development services in their respective markets. The team wanted to track the process of managing change when shifting from a service push strategy (free services) to building fee-paying MSME markets. The research design assumed that the necessary information to examine trends in service and client mix, revenues, and costs could be retrieved from the internal management systems at each of the centers. In fact, the business centers in the study were selected with the knowledge that the donor-supported implementing agencies had installed management systems—financial, client tracking, human resource—and provided training in their use. Beyond the data derived from these systems, the adoption, use, and modification of the systems and practices could serve as proxy indicators of commercialization. The combination of data analysis and the opinions and perceptions of business center managers and staff could provide a picture of how these

³ This report uses the term “implementer” to refer to the donor’s agent (e.g., DAI or IFC) that implements the program under which donor funds target the development of MSMEs in the Ukraine. Recent conferences on BDS by the Committee of Donor Agencies for Small Enterprise Development would properly refer to these agents as “facilitators” to denote their role as facilitating the work of local BDS suppliers (e.g., L’viv NewBizNet, ADE, and VCC) to serve customers, MSMEs, with a mix of business development services (e.g., training, consulting, and information).

three centers took up the challenge of becoming more commercial in their respective markets.

The research team found that the management systems were not being utilized, not because of the systems themselves, but because the proper and systematic use of “formal” systems conflicted with the more “informal” practices BSC managers perceived as necessary to improve revenue generation (for example, inflating costs and hiding revenues to reduce tax burdens). The lack of historical performance data—on clients served (size, type, age, whether new or repeat customers), revenues generated (by service and by source [SME, non-SME, other]), and costs and their allocation to different services—severely limited the use of the analysis framework that guided this research into how the centers were affecting and being affected by the business service market.

Revised Learning Framework

The absence of a comprehensive set of performance data, combined with the problems of understanding demand for business services in transitional market economies, led the research team to conclude that looking at an individual center was not a good indicator of what was happening in its market for business development services. Consequently, the team needed to develop another tool to present research findings and frame lessons about service flow to MSMEs through these centers, which it gleaned from interviews with business center staff, clients, and competitors.

The tool—presented in Table 1—focuses on the market context and not the “commercial process” of an individual BDS provider. The tool suggests that the “BDS market” in developing or transitional economic settings evolves through different stages as characterized by different levels of demand for and supply of services. The tool is not meant to be a static description, nor is there a clear boundary between one stage and the next. Rather, the tool illustrates how BDS supply and demand can evolve and the implications for donors and practitioners at the different stages. For example, one of the institutions studied was NewBizNet’s L’viv center. The research team’s observations suggest that over time the L’viv market has evolved from one of weak demand for services to one of greater demand, and from weak to increased capacity of business service providers. Using the tool, the L’viv market could be classified as “developing,” which in turn assisted the team in understanding the progress and prospects of the L’viv NewBizNet center in the context of customers and competing service suppliers. The tool could also be used to draw implications for donors about support options—both incentives and subsidies—that are consistent with the market context and donor goals to increase service flow to MSMEs.

Table 1: Evolution of BDS Market Context

Stage	Market Characteristics	Implications for Donors and Practitioners
Market Creation	The BDS market is characterized by the absence of customer demand for business development services from external suppliers. There are no viable organizations, and demand is difficult to assess because of the newness of the services being offered and lack of customer awareness.	With a nonexistent market, donors can focus on more intensive creation of new specialized business service institutions. Alternately, donors can focus on building the “raw material” (such as consultant training and product design and testing), which could lead to the creation of new service suppliers. This would require a project mechanism that could finance short-term activities such as training of trainers, exchanges, or travel grants to see business center operations elsewhere. Either donor strategy could be used to identify latent, or create new demand for, BDS while working to overcome supply constraints.
Market Development	The BDS market is developing but is weak, and the flow of services to MSMEs in particular is small and/or stagnant. There is typically only a handful of organizations providing services, and most are very weak. Demand is present but not very strong, especially paying demand from smaller firms.	Because local institutions already exist, one option for donors is to focus on developing a successful market leader or leaders that would spur new entrants, through a “café effect,” the phenomena where if a successful café opens, there is a strong likelihood that others will follow. Targeted subsidies and incentives would need to be provided as part of an overall institutional strengthening plan. Incentives should reward commercial behavior; that is, they should be pegged to the sale of services and/or profits instead of covering recurrent costs. Incentives should reward the use of sound commercial practices and systems while understanding that their adoption may be constrained by a hostile legal and regulatory environment. Another donor option is to focus on encouraging demand for services through policy advocacy, public education, and/or promotional campaigns. Public contracting using task orders could be used for targeting services to specific groups. Vouchers or discount coupons could also be used to induce trial of specific services.
Market Facilitation	The BDS market is still developing but growing, with solid demand and a broad range of service providers. The flow of services may be weak for certain services, and/or service gaps may exist for some MSME segments that cannot pay commercial rates for, or do not understand the value of, certain services.	In contrast to the previous two stages, donors can focus on facilitating the flow of services to desired market segments without necessarily underwriting the strengthening of specific service providers. At this stage in the evolution of the BDS market, the local institutional base is already viable and capable of adapting to meet most of the market's needs. The focus is on increasing the flow, or encouraging the direction of the flow, of services to MSMEs or targeted segments of the MSME community. Discount coupons, matching grants, public relations campaigns, and general education constitute the types of demand-driven efforts that could be applied.

As this report begins, it is equally important to note what this research does not cover. It was not designed to draw lessons on good, better, or best practices by comparing the performance of the business centers studied. Instead, the research team intended to identify the practices in each center that appeared to improve the center’s financial performance so that this

information could be documented and shared within Ukraine. The research does not claim to represent the full breadth of Ukraine's small and medium-sized enterprise sector support activities, either through business service centers, incubators, association building, or advocacy work. Rather, the research assumes that its intensive assessment of a limited sample of business service providers could contribute to future in-country research efforts by testing a set of research questions aimed at assessing the process of business center commercialization.

This report is organized in five chapters, including this one. The second chapter presents the Ukrainian context in which the business development service providers (BDSPs) and their clients operate. The third chapter provides an overview of the BSCs and the direct competitors in their markets. The fourth chapter discusses the findings of the research, looking at the experience of the BSCs in the start-up of programs, service mix, client focus, and financial viability. Finally, the fifth chapter identifies some promising practices for the BSCs in the commercialization of services, and discusses issues and challenges for business development services for MSMEs.

CHAPTER TWO

THE UKRAINIAN CONTEXT

Ukraine, which celebrated its eighth anniversary of independence in August 1998, has since followed a course of democratic development, social stability, and determined but slow-moving economic reform. Since independence, Ukraine has accomplished much on the economic front—it has curbed inflation and introduced a new currency—but much work still lies ahead to create an enabling environment for a market-based economy. In 1994, the Kuchma government took up a more aggressive reform agenda. The results have been substantial. By 1997, inflation had been brought down to 10 percent, from more than 400 percent in 1994⁴, and the fall in the gross domestic product (GDP) had also been reduced and remained relatively constant for 1998 (estimates range from -1.5 percent to +0.6 percent).

Although there is certainly reason for optimism regarding the country's macroeconomic picture, serious issues have yet to be addressed in regard to building an enabling environment for businesses, especially MSMEs. Fiscal policies have improved, but tax policies and tax administration overburden Ukrainian enterprises.⁵ Reforms in these areas have been ineffective or even counterproductive. For example, the restrictively high tax rates and complexity of the procedures for assessing tax burdens have resulted in substantial incentives for businesses to avoid paying taxes. It is often noted that if a business were to operate as mandated by law, it would be impossible for it to make a profit. Although this may be extreme, there is certainly a widespread belief that avoiding taxes is critical to a company's financial viability.

Compounding the country's tax issues are business oversight procedures (inspections, licensing, reporting, and so on), which have been estimated to require as much as half of a manager's time. According to an International Center for Policy Studies' survey,⁶ businesses needed at least three licenses to operate, requiring an average of 2.6 employees to work 3.5 hours a day for 20 days to obtain each license. The survey also identified the business registration process as highly burdensome, with the amount of time needed to register a business ranging from 34.7 to 270 days, including the efforts of 3 employees taking 3.5 hours a day. Once registered and with the proper licenses, the survey found, a business was subject to seven tax, five health, three police, and three environmental inspections annually. Each tax inspection, for example, took an average of 10 days and required that the business provide all the equipment and office space for the inspectors. In all situations, a judgment against the business was difficult to appeal, if an appeals process was even available.

The net effect of these heavy financial and administrative burdens has been significant growth in the informal sector. The "unofficial," or shadow, economy is estimated at 40

⁴ Ukraine, *1999 Country Commercial Guide*, U.S. & Foreign Commercial Service and U.S. Department of State, 1998.

⁵ See USAID/Kiev Mission Strategy Statement.

⁶ International Centre for Policy Studies Quarterly Predictions, 1995-1997.

percent to 60 percent of official GDP.⁷ Although much of the government's tax revenue crisis is related to businesses actively hiding revenues, the government's lack of administrative capability has made the situation substantially worse.

This dichotomy of promising economic underpinnings combined with overly burdensome regulatory and tax structures has made Ukraine's BDSPs critical to the process of reform. It is through these organizations that businesses, especially small and micro establishments, receive assistance that prepares them for operating in a market environment and facilitates their faster growth. In providing these services, BDSPs act as an important bridge between the informal and formal sectors, and develop a solid understanding of issues facing businesses in Ukraine. Donors have understood this dynamic and have actively supported BDSPs to develop businesses' ability to be financially viable. To achieve this end, BDSPs have focused on the commercialization process, or the process of developing fee-paying clients for a differentiated mix of services. In support of this effort, donors have encouraged different strategies to accomplish this goal.

⁷ See USAID/Kiev Mission Strategy Statement.

CHAPTER THREE

OVERVIEW OF THE BUSINESS SERVICE CENTERS IN THE STUDY

DONOR-FUNDED BUSINESS SERVICE CENTERS

The research team studied three donor-funded business service centers for this study:

- The Agency for the Development of Enterprise (ADE), funded by European Union Technical Assistance to the Commonwealth of Independent States (EU TACIS) through a contract with EDAW-TSD;
- The L'viv NewBizNet Business Service Center (L'viv BSC), funded by the U.S. Agency for International Development (USAID) through a contract with Development Alternatives, Inc. (DAI); and
- The Vinnytsia Consulting Center (VCC), funded by USAID through an agreement with International Finance Corporation (IFC).

Table 2 summarizes the establishment of the BSCs: their registration status, entry orientation, and donor-funded investments and subsidies.

Table 2: Overview of Donor-Funded BSCs

	ADE	L'viv BSC	VCC
Location	Capital city, Kiev	Western regional center, L'viv	Central regional center, Vinnytsia
Population	2.5 million	850,000	375,000
Registration status	joint stock company (JSC)	JSC	Employee-owned limited liability company
Entry orientation	Nonprofit	For-profit	For-profit
Year established	1993	1990	1997
Date services started	1/95	9/90	5/97
Date of current registration	4/94	10/95	2/98
Initial donor investment in infrastructure and equipment	\$75,000 (est.)	\$172,221	\$30,000
Operational subsidies to date	\$400,000 (est.)	\$121,450	\$70,000
Technical assistance to date	\$2 million (est.)	\$980,000 (est.)	\$360,000 (est.)
Other donor-funded contracts	\$23,000 + the Basic Business Information Department	\$123,000	none
Date donor funding ends	11/99 (est.)	9/99	5/99

Agency for the Development of Enterprise

ADE, in Kiev, Ukraine, was established in 1993 with assistance from the European Union under a TACIS program in accordance with an agreement with the Government of Ukraine.

As part of the endeavor, Northern Ireland Public Sector Enterprises, Ltd. (NICO) had been contracted to create a consulting agency. At first, NICO attempted to work with a government-supported entity, the Ukrainian League of Industrialists and Entrepreneurs, which NICO hoped would serve as a MSME support organization. It was determined, however, that the league, which consists of the largest enterprises in Ukraine, did not have an interest in serving the MSME sector. Consequently, EU TACIS and NICO established ADE instead, as a stand-alone company.

ADE is currently EU TACIS's largest MSME program in Ukraine, with a branch office in Sevastopol, in southern Ukraine, and the majority shareholding (51 percent) in a center in Vinnytsia. EU TACIS plans to establish two to four additional centers in 1999. This time, however, rather than creating new BSCs, EU TACIS expects to help existing centers create a network of agencies that can work together to achieve sustainability.⁸

As illustrated in Table 2, ADE was registered as a joint stock company with a nonprofit statute in April 1994 and began servicing clients in January 1995. The initial investment in infrastructure (office renovations) and equipment (furniture, computers, and the like) is estimated to have been approximately \$75,000. A team of six Western experts and many short-term consultants established and ran ADE until August 1997. The current contractor, EDAW-TSD, has one long-term advisor stationed at each of the three ADE centers. ADE continues to benefit from training and services provided by short-term consultants. To date, operational subsidies and technical assistance have totaled approximately \$400,000 and \$2 million, respectively.

Currently, ADE employs 15 people full-time. This is down from a high of 22, when two other EU TACIS projects that were set up at the same time as ADE, the Project Preparation Unit (set up to develop business plans) and the Business Communication Center, were merged into ADE. (Several consultants to the PPU left to create their own consulting company.) ADE's primary services are now organized into four departments: Training, Business Consulting, International Links (partnership searches), and Basic Business Information (BBI), each headed by a team leader. BBI is currently funded by the Italian Government and provides free information to emerging entrepreneurs on business start-up, legislation, taxation, and possible sources of financing. ADE hopes to find additional donor support to continue BBI's services. If funding is not available, the department will be incorporated into ADE's menu of core services.

ADE rents space to another EU TACIS-funded project, the Retraining and Employment for Former Military Officers Project, and has received a \$23,000 grant from the Eurasia Foundation to support the publication and free distribution of the *Entrepreneur's Handbook: Small and Medium Business Support Programs in Ukraine*, in printed and electronic versions.

ADE was originally established as a business development agency to serve the MSME sector. Commercial viability has only recently become a concern with the current EDAW

⁸ Interview with Eleonora Nikolaichuk, program officer, EU TACIS, September 30, 1998, in Kiev, Ukraine.

contract, which was awarded in August 1997. EU TACIS anticipates continuing support through November 1999 under a new contract.

The L'viv NewBizNet BSC

The L'viv NewBizNet BSC was established in 1990 as the Research and Consulting Center of the L'viv Institute of Management (LIM). LIM provides courses in practical business skills and offers an MBA degree program that is modeled on U.S. standards.⁹ In December 1992, the center changed its name to the Business Service Center. In 1995, the BSC won a competitive bid to become one of four BSCs affiliated with the NewBizNet Project, implemented by DAI and funded by USAID; hence the center's current name, L'viv NewBizNet BSC. The mission of the BSC is *to assist the private business sector in Ukraine in achieving growth and prosperity*.

The NewBizNet Project is designed to strengthen leaders in a weak BDS market to become viable, full-service BSCs. NewBizNet's three other BSCs are in regional centers in Kharkiv, in eastern Ukraine; Odessa, in southern Ukraine; and Chisinau, Moldova. DAI is currently in the process of subcontracting with five additional BSCs in smaller regional centers throughout Ukraine.

A condition of the subcontract with DAI was that the L'viv BSC become an independent entity for control and transparency purposes. The "Business Support Center—NewBizNet" was registered on October 13, 1995, as a joint stock, for-profit company headquartered in L'viv. The share capital of \$9,200 (17,104 UAH) was paid in full by LIM, the 100 percent owner of the L'viv BSC, at the time of registration.

The NewBizNet Project facilitated the BSC's move to a large, centrally located office, which was renovated to Western standards at a cost of \$44,475. Office furniture and equipment cost an additional \$139,330, of which \$11,584 was paid for by the L'viv BSC. Two short-term technical advisors conducted the due diligence and provided technical assistance for an initial period of nine months, and were followed by a long-term advisor whose assistance ended in June 1997. The L'viv BSC is supported by a project coordination center (PCC) located in Kiev and staffed with legal, financial, computer, training, and consulting experts. The total cost of technical assistance for the L'viv BSC to date is estimated to be approximately \$980,000.

The L'viv BSC provided consulting services to large, restructuring Ukrainian companies before becoming affiliated with the NewBizNet Project. The L'viv BSC is currently structured into the following service units: Training, Business Advisory Services, Business Information Network Services, and Other. The Other category includes partner searches, office support services (faxing, photocopying, translation, and so on), and personnel recruitment, an outgrowth of a \$23,000 "Youth Employment Exchange" program funded by

⁹ LIM is a member of the European Foundation of Management Development.

the Eurasia Foundation. The L'viv BSC will also participate in a \$100,000 cross-border training and exchange program funded by EU TACIS.

The staff of the L'viv BSC consists of 15 full-time employees, a NewBizNet PCC representative, and a Peace Corps volunteer. The BSC depends heavily on part-time staff and outside contractors, drawing upon its ties to LIM. Operational subsidies, rent, salaries, and office expenses for the three years ended September 1998 totaled \$121,450. These subsidies are scheduled to end in September 1999.

The Vinnytsia Consulting Center

The Vinnytsia Consulting Center, in Vinnytsia, Ukraine, was established in February 1997 based on agreements between regional government authorities and IFC as part of the latter's Post Privatization Project (PPP). (IFC works at the invitation of local Ukrainian authorities, either oblast [regional] or city governments.) This agreement enabled the VCC to operate as an independent center while also securing a commitment from the regional administration to provide rent-free premises to the BSC for four years.

The VCC is one of four BSCs IFC established in 1997 using USAID funding. IFC also established four BSCs in 1994, with funding from the British Know How Fund (BKHF). IFC plans to establish three additional BSCs in its next project cycle, again with USAID funding.

The VCC began operations in May 1997 but was unable to charge for services (training, consulting, and the provision of business information) until it was registered on February 10, 1998. Initial investments in infrastructure (renovation of office space) and furniture and equipment totaled approximately \$30,000. Operating subsidies, which were scheduled to end in May 1999, totaled approximately \$70,000 through September 1998.

Two IFC representatives established and ran the center for six months before turning it over to the local director. The VCC currently has seven full-time staff members and a part-time interpreter. IFC continues to provide staff training, product development, and marketing support to the center through the PPP office in Kiev, and supports the costs of two Peace Corps volunteers who are assigned to the center. The total cost of technical assistance through September 1998 was estimated at \$360,000.

COMMERCIAL SERVICE PROVIDERS

The original intent of this research was to provide a descriptive assessment of existing commercial service providers operating in the markets of the donor-assisted centers (from those providing basic administrative services to those providing legal and accounting help). This was done to obtain a broader picture of the market for business services.

The research team hoped to learn (1) which services had been commercialized; (2) what businesses were being served; and (3) whether there were any links (similar clients or related

services) between the commercial providers and the donor-assisted BSCs. Because of severe time constraints, a decision was made during the course of the fieldwork to look only at a few of the BSCs' direct commercial competitors (as defined by BSC managers), in order to gain a deeper understanding of the commercialization of BDS. The directors and staff members of these competing companies were interviewed for this study.

Staff members of two of the BSCs cited educational institutions as direct or potential competitors, particularly in the area of training. However, the educational institutions were ranked as weak overall competitors because the institutions did not take demand signals to adjust their products to the needs of the consumers. For example, they continued to provide long-term training—a month or more per training course—at a time when consumers were sending signals for short-course training. The research team did not include a competitive analysis of educational institutions in this study, because the BSCs themselves did not regard them as strong competitors.

Kiev

Kiev is the capital and largest city of Ukraine, with a population of approximately 2.5 million. It is a sophisticated service market, represented by international law firms, the Big Six consulting firms, multinational market research companies, and smaller, indigenous consulting companies. Among the consulting companies offering services similar to those ADE provides to the same clients are Kiev Management Konsult (KMK), International Consulting Group (ICG), and the Institute for International Business Development (IIBD). All three companies have benefited from donor assistance—either directly or indirectly.

- KMK was established in 1994 by five graduates of an EU TACIS-funded training-of-trainer program in consulting and training. The company currently employs 17 full-time and 30 part-time experts in four specialized fields of service: training, consulting, recruiting, and project management.
- ICG began as the Project Preparation Unit (PPU) of an EU TACIS program that included ADE and a Business Communication Center (BCC) established in the Ukrainian Chamber of Commerce. Three members of the PPU split off and formed an independent consulting company after attempts were made to consolidate the PPU and the BCC into ADE. ICG specializes in market research and business planning for financing from the European Bank for Reconstruction and Development (EBRD) and the World Bank.
- IIBD was established in 1995. Six full-time staff members provide consulting, foreign partner search, and training services. They work closely with Western universities and bilateral and multilateral donor organizations, and have benefited from their training programs and referrals.

L'viv

L'viv (population 850,000) is the center of the largest oblast (region) in western Ukraine (population 2.7 million). L'viv is at the crossroads of several major highways and railways

and is located near the borders of Poland, Slovakia, and Hungary. The L'viv BSC's target market area includes five out of eight oblasts in western Ukraine with a total population of 7.5 million.

The L'viv BSC groups its competition into the following categories: (1) Kiev-based consulting companies that have expanded their activities into western Ukraine; (2) specialized consulting companies; (3) business incubators; (4) educational institutions; and (5) the 30 or so companies in the L'viv region that offer low-priced (and, according to the L'viv BSC, low-quality) consulting services. Of these, the BSC has determined that its principal competitors are the specialized consulting companies in the L'viv region, which include the L'viv Consulting Group (LCG), Western Ukrainian Management Consulting (WUMC), and Smart Marketing Group (SMG). The research team also looked at Meta Center, a newly established business incubator.

- LCG is a local company with a mix of Western and Ukrainian consultants (eight full-time staff) whose primary mission is to assist Ukrainian companies in securing Western capital. Established at the same time as the L'viv BSC was registered (October 1995), LCG also provides training services through the Center for International Management Education, which was established in 1990 by one of LCG's founders.
- SMG is a commercial service provider whose founders split off from the L'viv BSC in early 1995 to specialize in marketing and market research. SMG currently has 11 full-time employees and 40 part-time interviewers.
- WUMC is an EU TACIS-funded post privatization center that was established in 1997 to provide services to restructured medium-sized enterprises.
- Meta Center is a USAID-funded incubator with a loan fund that provides consultancy and training. Meta Center has 9 full-time staff members, including legal and accounting staff.

Vinnytsia

Vinnytsia is a small city of 375,000 inhabitants located approximately four hours from Kiev. The VCC's only direct competition would have been the EU TACIS-funded ADE, which had intended to open a branch office (center) in Vinnytsia in May 1998 until IFC reached a compromise with EU TACIS allowing ADE to retain a 51-percent share in the center (called ADE). The VCC, meanwhile, purchased 15 percent of the center to become its second-largest shareholder. The VCC and ADE coordinate services and share clients based on a cooperation document that outlines the services each is to provide. The VCC and ADE share a managing director and a secretary/office manager to coordinate the services between the two centers. Regarding the educational institutions in the region, the VCC says they offer low-quality business-related courses and have little flexibility to create new ones. Therefore, these institutions do not pose any real competitive threat to the VCC.

CHAPTER FOUR RESEARCH FINDINGS

This study examines four key variables in the BSCs' experiences with the process of BDS commercialization: start-up of programs, service mix, client focus, and financial viability. Each variable will be discussed within the market framework of creation, development, and facilitation. "Start-up of Programs" (below) looks at implementation methodologies, entry orientation, and stakeholder commitment. "Service Mix" analyzes the responsiveness of the BSCs to the changing needs of the marketplace. "Client Focus" examines how the commercialization process is affecting and being affected by demand. Lastly, "Financial Viability" looks at the likelihood of sustainability and the effects on viability of incentives/subsidies and the adoption of better business principles and practices.

START-UP OF PROGRAMS

Market Creation

In this context, the BDS market is characterized by the absence of interaction between MSME customers and business services providers. ADE and VCC are positioned in this context because of how they saw the BDS market in their respective locations.

NICO, the original contractor for EU TACIS, believed that no BDS providers existed in Kiev in the early 1990s besides the Big Six consulting firms, and that none served the MSME market. ADE was created as a business development agency to serve the MSME market, which was not ready or able to pay commercial prices for services.¹⁰ IFC, working in smaller markets, believed business support service provision in these markets had not developed to the point of providing a wide array of services that could foster MSME development.¹¹ To "create" a market that would serve MSMEs, both NICO and IFC started local institutions that offered a range of business support services.

Agency for the Development of Enterprise

EU TACIS and NICO originally attempted to create a sustainable institution for the support of MSMEs by establishing ADE within the Ukrainian League of Industrialists and Entrepreneurs (ULIE), a government-supported entity. The donor and implementer soon realized, however, that ULIE did not have an interest in serving the MSME sector, and so decided to create a stand-alone BSC. Six long-term technical experts working with four

¹⁰ Interview with Irina Moriakina, business advisor, ADE, September 22, 1998, Kiev.

¹¹ Interview with Thomas G. Rader, project manager, IFC Post Privatization Project, September 24, 1998, Kiev.

Ukrainian support staff created the structure of ADE and hired the initial staff of 13.¹² NICO short-term experts trained the business advisors, trainers, and marketing and promotion officers. Study tours to Italy and Northern Ireland were also provided as part of the training for new staff members. The NICO team, which remained for three years, determined the service mix, implemented the marketing plan, managed the service departments, and provided training and consulting services.

It took NICO several months after the decision to create a new entity apart from ULIE to determine the form of registration, identify a board of directors, hire staff, and procure premises in order to register ADE. As illustrated in Table 2 in the preceding chapter, it took ADE nine months after registration to begin serving clients. EDAW-TSD, the current contractor, has a long-term technical expert in each of the three ADE centers. Short-term consultants continue to provide training for staff members and deliver training courses for clients.

ADE was registered as a joint stock company in April 1994 with 16 shareholders,¹³ none of whom has a controlling share in the company (the largest shareholder owns 16 percent of the capital shares). Financial viability was not a concern at the time of registration, and ADE was registered with a nonprofit statute (meaning all profits ADE generates must be reinvested in the centers). The shareholders are reported to have lost interest in ADE because of the nonprofit statute but continue to maintain shares for political and prestige purposes.¹⁴

One of EDAW-TSD's objectives has been to improve ADE's income-earning capacity while respecting the tasks and functions of a MSME development agency.¹⁵ ADE staff, however, asserted in interviews that they were more committed to delivering services than achieving commercial viability. Their view has been that self-sufficiency can only be reached by drastically reducing free or nominally priced services and by starting activities that bear little relation to the support of the MSME sector, such as engaging in trade. To date, EU TACIS has not reconciled the dual, sometimes contradictory, nature of the requirements for ADE; namely, to increase the percentage of cost recovery on one hand while providing noncommercially viable services to the MSME sector on the other.

The Vinnytsia Consulting Center

IFC aims to create new institutions in cities or regions lacking integrated business service providers. IFC works at the invitation of governments and signs memoranda of understanding for individual technical assistance assignments. In Vinnytsia, this process has enabled IFC to obtain a commitment from the oblast government to provide rent-free premises to the VCC for four years. Two representatives of IFC established VCC with an initial staff of five. IFC identified consultancy staff through a competitive personnel selection process, provided hands-on training for staff, determined the service mix, and managed the

¹² Ms. Ludmila Yakovleva, former vice president of ULIE, was named director of ADE.

¹³ Mostly large private sector Ukrainian companies.

¹⁴ Interview with Ludmila Yakovleva, director, ADE, September 21, 1998, Kiev.

¹⁵ "EDAW-TSD Project Synopsis," unpublished, 1997.

VCC for six months before turning the center over to the consultant selected as the managing director.

Rather than appointing a director immediately, IFC managed the center during its first three months in order to assess staff performance. It then began a three-month transition period with an experienced local IFC representative before leaving the director to manage the center. Finding qualified, experienced staff has been difficult for the implementing agencies, particularly in small markets like Vinnytsia (which is also close to an attractive labor market in Kiev). IFC hired staff with varied experience who were eager to broaden and deepen their training. The VCC began serving clients three months after IFC made initial contacts with the Vinnytsia regional administration for office space. The center was not officially registered, however, until February 1998 and could not legally charge for services until then.

IFC not only provides direct training support for the VCC through its Post Privatization Project office in Kiev, but it also provides a continuous process of skills updating and knowledge transfer, implementing new management systems as well as having the VCC participate in business center network joint activities. These include training, consulting projects, and information sharing. Two Peace Corps volunteers, one specializing in marketing and the other in accounting and finance, also provide technical assistance to the VCC.

VCC was registered as an employee-owned limited liability company. Four consultants (including the director) each have a 19.75-percent stake in the company. The three support staff have a 7-percent stake each. IFC recommended employee ownership as a means of building stakeholder commitment up front. At the time of this research, the employees had paid in 7 percent of the required statutory capital of 10,000 UAH (approximately \$5,000), while IFC had paid 23 percent as a “bonus” for the employees. The remaining 70 percent was to have been funded by February 1999.

Summary of Findings

- **The creation of new business service institutions requires an enormous amount of time and effort**, as illustrated by the actions of NICO and IFC: identification of markets; determination of ownership and structure; creation of bylaws; heavy up-front investments in infrastructure and equipment; identification and training of staff; and continued technical assistance. It took NICO approximately two years to register ADE and enable it to begin serving clients. It took IFC one year to do the same.
- Creating new institutions offers the advantage of starting with individuals, rather than institutions, and being able to start without liabilities of any kind. The challenges of this approach are to select social entrepreneurs and build an institution around them; match the organizational structure with the intent of the institution; build owner and employee stake as early as possible; and balance donor requirements in the institution (e.g., transparency) with local commercial operating practices. The closer the creation approach approximates a commercial venture (self-selection and capital investment), the

more market oriented a center is likely to be. **A commercial orientation and culture at the outset are critical to future sustainability**—it is difficult to shift orientation midstream. Additionally, building a stake by staff in the BSC from the outset is key to providing the right staff orientation.

- ADE’s corporate structure no longer fits the donor’s intent to move the organization toward commercial viability. Originally, ADE modified a legal, commercial structure—the joint stock company—with a nonprofit statute to fit the intent of the creation of a nonprofit business development agency. Now, however, the altered structure and orientation of staff do not fit EU TACIS’s intent. ADE staff are resistant to the commercialization of a large segment of their services.
- The VCC’s ownership structure was intended to build employee stake in the center from the outset. However, each employee’s initial investment in the statutory capital was substantially less than a month’s salary.

Market Development

In this market context, both the demand for and supply of business development services exist but are weak, with little flow of services to the MSME sector. However, market leaders or niche providers can be strengthened to increase the flow of services to MSMEs. DAI selected an institution—the L’viv Institute of Management—that was already providing services to a client group with the objective of diversifying its clients to include MSMEs by building on LIM’s existing training and consulting products serving larger businesses. DAI’s approach in L’viv is consistent with a “developing” BDS market context; however, the research team found that DAI took a resource-intensive approach at start-up, which may have been warranted in the L’viv market.¹⁶

The L’viv BSC, an operating unit of LIM, was selected for assistance based on a nationwide competition of BDSPs (excluding the capital city). DAI made a large initial investment in infrastructure (office renovation) and equipment, moving the BSC to a large office in a centrally located building. DAI also installed Western-style financial reporting and client-tracking systems; expanded services to include short-term training and the provision of business information; placed a long-term technical advisor at the L’viv BSC until June 1997; and continues to provide technical support through the project coordination center in Kiev. As a result, BSC staff have increased from an initial 7 to 15. In sum, DAI identified a market leader in L’viv but altered it so much that it created an entirely new organization.

Summary of Findings

1. Market development offers the following advantages:

¹⁶ Start-up costs included capital to refurbish office space, purchase equipment, and place a long-term technical advisor within the center’s management.

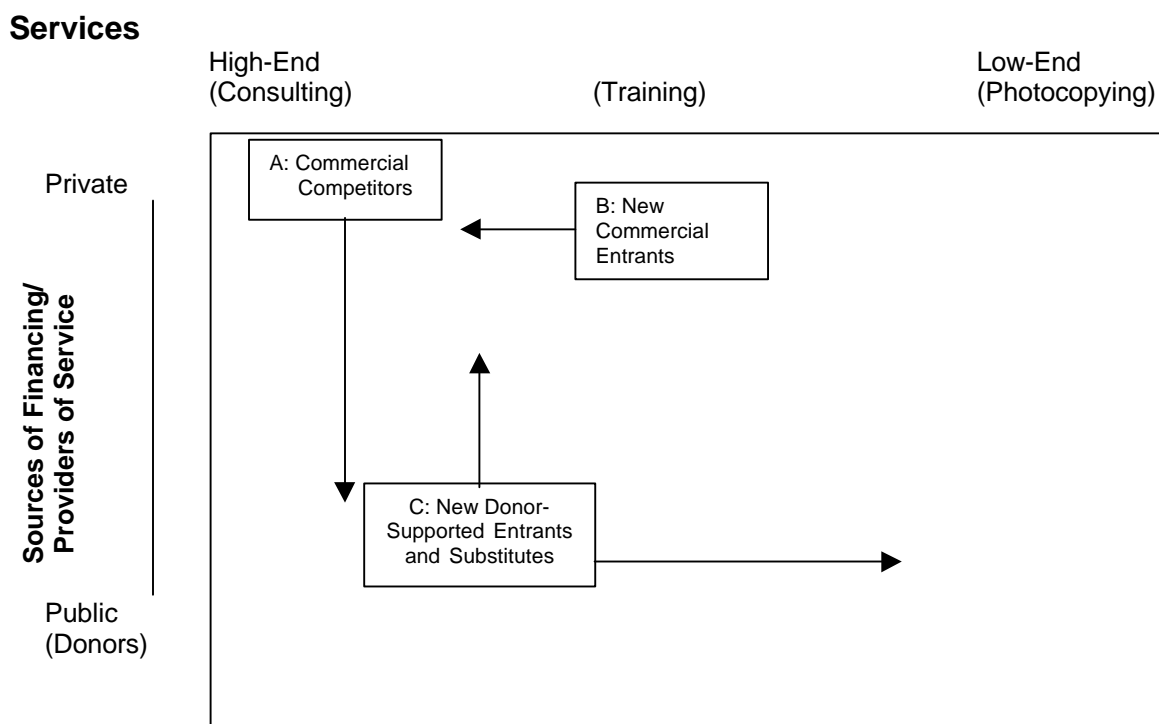
- As an independent commercial start-up, it had a pre-existing sustainability orientation,
 - Existing staff experienced in the provision of business support services,
 - An existing client and revenue base,
 - A sense of ownership and independence by the BSC, and
 - The commitment of stakeholders.
2. Disadvantages of working with an existing organization include the greater likelihood of an entrenched “old school” mentality and the possibility that the organization may have more than one agenda (besides serving the MSME sector), making it difficult to reorient the institution.

In the case of DAI’s NewBizNet Project, institutional development proved to be a difficult task of balancing the use of incentives to encourage client diversification within an existing organization versus creating a “new” institution by mandating different services, systems, and structures. In this market context, the expectation is that donor support should accelerate the flow of services to MSMEs more efficiently (that is, using less time and money). Incentives should be used to broaden an institution’s client base to include MSMEs, with the expectation that the client base will grow over time. As with market creation, this raises the issue of the role of donors in the BSC’s client portfolio, and how that role might strengthen or distort market signals from the MSME segment for business services.

Market Facilitation

In Chapter One, Table 1 suggested that as BDS markets evolve, they will be characterized by effective demand for services and a range of service providers specialized by service and/or client mix. Even in this market context, there may be a role for donors to encourage the direction and volume of service flow to MSMEs. A review of the commercial service providers in the larger markets of the donor-supported BSCs indicates that the BDS market for MSMEs is becoming more dynamic.

Figure 1, below, provides a picture of the BDS market as it emerged through the research. The table positions the BSCs’ competitors by two variables: their service mix (ranging from high-end market research or specialized training to low-end services such as photocopying and basic training), and their resources and revenue sources (ranging from the public sector and donors to private companies). As illustrated by the figure, a range of service providers exists in Ukraine in addition to donor-supported business service centers. Commercial service providers that serve multinational and large Ukrainian companies (Box A in the figure) are responding to donor signals and contracting with them to provide services to targeted segments of the MSME sector (as indicated by the arrow). New commercial entrants that started out as training providers (Box B) are expanding their service mix to include consulting. Educational institutions (Box C) provide training and low-cost consulting services. Additionally, new donor-funded entrants (Box C) continue to emerge, with most seeking to move toward commercial viability. The direction of the arrows indicate these trends.

Figure 1: BDS Market in Ukraine

Training has proved to be an effective means of stimulating private-sector BDS. Consultants who have participated in stand-alone training-of-trainer (TOT) programs or been trained as staff members of donor-supported BSCs have started their own companies. In some cases, these commercial service companies began operations at about the same time as the early BSCs (1994 to 1995), effectively competing with the centers for the same client base. The commercial service providers have been able to adapt quickly to market conditions to provide services efficiently. However, they must fund new-product development and expansion entirely by income or investment; therefore, growth is limited among service companies with little or no collateral to obtain outside financing. Despite these restrictions, some BDSPs have expanded in service and client mix and have reached the size of the larger donor-supported BSCs in their number of employees.

Several donor-funded programs and organizations (EU TACIS's Bistro Program, the Eurasia Foundation, the Renaissance [Soros] Foundation) are currently using small-grant mechanisms to reach target client groups and regions. Grants, which range from \$2,000 to \$100,000, are spread through a wide range of local service providers, from the government to private and for-profit organizations to nonprofit entities.

EU TACIS recently completed a series of training programs for bankers and MSMEs contracted through the Institute for International Business Development (in cooperation with the London Center for Economic Development). EU TACIS intends to conduct the next series of seminars in smaller cities that are not served by BSCs.¹⁷

¹⁷ Interview with Eleonora Nikolaichuk, program officer, EU TACIS, September 30, 1998, Kiev.

The Eurasia Foundation's grants in the field of business development have been primarily for low-cost training, information dissemination, and short-term consultations for specific target groups (agricultural enterprises and women-oriented groups) in larger cities, or for entrepreneurs in areas that are not served by business service providers.¹⁸ The foundation plans to implement a targeted initiative this year to link smaller markets that are not currently served with existing regional BSCs experienced in the provision of services. The assistance may be for a top-down approach, for BSCs to provide outreach services to smaller towns in the region, or bottom up, for organizations to purchase services from larger regional BSCs. For the future, Eurasia is also considering recoverable grants (based on revenues generated from fees) and commercial loans.¹⁹

Summary of Findings

The commercial companies that have emerged as BDSPs have been self-selecting. Yet donors have played a key role in developing the human capacity to provide services to assist MSMEs in Ukraine. One of the direct results of donor-supported TOT programs for consultants and trainers and an indirect result of donor-funded BSC creation and development has been the indigenous development of commercial business service providers.

SERVICE MIX

Market Creation

All donor-supported BSCs were initially set up to offer a supply-driven service mix of three core categories: training, consulting, and business information. Staff were trained in the delivery of off-the-shelf training programs, business planning, and marketing; investments were made in computer equipment for database development and management; and advisors provided ongoing technical assistance and database updates. Once the initial sets of services were in place, the BSCs were encouraged to develop their own core competencies based, in part, on staff experience and market evolution. (The L'viv BSC was required to maintain the three core service categories, but the choice of specific services and service emphasis was largely left to its own commercial judgment.) While the three BSCs studied did make adjustments in emphasis on specific services, primarily in the training divisions, all continued to maintain services in each service category, even when sustainability was clearly a concern. Most staff members interviewed for this study said they believe they must provide all services to all clients, regardless of the latter's ability to pay, as long as they receive donor support.

¹⁸ "Summary of Grants Awarded in the Field of Business Development in 1995-1998 (as of September 15, 1998)," the Eurasia Foundation, Western NIS Regional Office.

¹⁹ Interview with Nick Deychakiwsky, director, Western NIS Regional Office, the Eurasia Foundation, October 5, 1998, Kiev.

The research team was unable to obtain detailed information from each BSC on specific services within the broad service categories listed above, such as price or client lists by service, or revenue by specific service. Nor was the team able to obtain adequate historical information (even going back one year). ADE staff had stopped updating their client database as of March 1998; the L'viv BSC had adopted a new financial management and reporting system for the current fiscal year, making comparisons with prior year figures meaningless; and the VCC had only been in operation for six months. Therefore, it was difficult to analyze changes in services, prices, and costs.

Table 3, below, shows the breakdown of revenues by broad service category for the three BSCs for fiscal year 1998, which serves as an indicator of service interests. (The three BSCs also offer allied office support services such as photocopying, faxing, e-mail, Internet access, and translation, although these services are not tracked separately.)

Table 3: FY98 Percentage of Revenues by Department

Revenues by Department	ADE	L'viv BSC	VCC
Training	35%	38%	65%
Consulting	30%	34%	22%
Business Information	19%	25%	7%
Other	16%	3%	6%
	100%	100%	100%

Training

Training courses range from generic, off-the-shelf seminars on business entry, skills development, and business management to customized courses by firm type on effective sales, negotiations, and time management. In a market-creation context, BSCs need to offer off-the-shelf, proven training courses to attract clients. These courses are also the easiest service for a newly created BSC to provide. As illustrated in Table 3, 65 percent of the VCC's (the newest BSC) revenues are generated through training, while ADE's revenue stream is more evenly divided between training and consulting. As market demand has evolved and the competitive environment has changed, BSCs have had to change the training courses they offer or develop new ones. When ADE first began operations in 1995, its Training Department started by offering a course called "How to Start Your Own Business." Now, ADE's clients are more interested in courses in marketing; business planning; financial management; sales; and time, change, and project management.²⁰

- Business entry courses (entrepreneurship training, such as "How to Start Your Own Business") are provided to emerging entrepreneurs, often at no charge or for a symbolic fee.
- Skills development courses attract individuals looking for employment or career advancement. The most popular courses are basic computer training and training in a

²⁰ Interview with Leysa Ovcharenko, Training Department manager, ADE, September 22, 1998, Kiev.

widely used Ukrainian accounting software package (1-S). (At the L'viv BSC, these courses are offered continuously, limited only by the number of computers available for training.)

- Business management courses are geared for working professionals and include personnel management, financial management, and marketing. These courses are usually given on demand and are not frequently requested.
- The BSCs have responded to market demand in developing tailored training courses for wholesale companies with multiple retail outlets that request training for staff in effective sales, negotiations, time management, and team building. If managed properly, these clients can become long-term, repeat clients, as retail staff turnover is very high. In developing these courses, the BSCs have received assistance from staff at the implementing agency's project coordination offices or from Western consultants.

Tailored training courses for trading companies with 5 to 10 retail outlets have become "best sellers" for ADE's Training Department. This does not mean, however, that the courses are profitable for ADE. According to the department's manager, ADE loses money when working with small and medium-sized firms, which constitute the majority of its clients. Typical prices are 100 UAH (approximately \$50) per participant for a three-day course on nonfinancial topics, with discounts for repeat clients. (ADE offers a 10-percent discount for the second course and a 20-percent discount for the third course.) Even at 100 UAH for a three-day course, clients complain, claiming that because ADE is supported by EU TACIS, it should provide the courses for free. (Equivalent financial management courses are 200 UAH.)

ADE's strategies for sustainable service delivery to MSMEs are to find donor programs to provide training courses and to make the courses short, in order to minimize both cost and time for clients. (The most popular courses are three-day and one-week programs.) Again, according to ADE's Training Department manager, ADE can make money only when it works with large clients. (For example, ADE charges such firms \$100 to \$250 per day of work, depending on the type of activity, including pretraining research and after-training consultation.) However, there is a lot of competition for large clients.²¹

The VCC is developing and testing a course called "Methods of Successful Sales," in conjunction with the IFC coordination center in Kiev and the IFC-supported Dnipropetrovsk business center. (See Box 1, below, for details on the development of the course.) The course was tested in Kiev at a pilot price of 15 UAH (approximately \$7.50) for a one-day seminar. According to the marketing specialist at the VCC, a price of 30 UAH would cover costs. That was in contrast to other seminars conducted in Kiev by competitors, which cost up to \$100 UAH (approximately \$200) per day.²² The research team did not learn how the VCC would price the seminar after development was completed.

The VCC has also developed and delivered a course on budgeting for companies in which the Western Newly Independent States Enterprise Fund (WESTNIS) has invested. The VCC

²¹ Ibid.

²² Interview with Tatiana Antonova, marketing consultant, the VCC, September 14, 1998, Vinnytsia.

was able to maximize its investment in the development of the course by conducting the same training for a local beverage manufacturing company. These courses have been profitable for the center. The two contracts for the WESTNIS companies generated a 32-percent profit and approximately 60 percent of the revenue for the six months since the VCC was registered.

The experiences of ADE and the VCC illustrate the challenges of trying to build a sustainable, fee-paying market for services for MSMEs. In order to attract clients to try a service, the BSCs usually price below cost to get people in the door. Once clients are in, however, the BSCs have a very difficult time raising prices to cover their costs.

Consulting

Consulting services include information on business registration, preparation of business plans for financing, and market research. Business-registration information and services are usually free of charge or cover minimal costs, as a service to the MSME community. (Few BSCs track these clients to determine whether the service is a good business development tool.)

Ukrainian MSMEs do not use business plans as management tools. Instead, they view business plans as necessary documents to obtain financing from nontraditional sources, such as foreign investment funds (including the German-Ukrainian Fund and WESTNIS's Small Business Loan Fund) and special lines of credit provided by multilateral institutions (such as EBRD). Therefore, a BSC's success in consulting directly correlates to its ability to secure financing for its clients. The L'viv BSC Consulting Department has shown success in this area and has staked its income on its ability to help clients obtain financing (see Box 2).

Market research is a relatively new product for the BSCs in this study, and local demand is

Box 1: "Methods of Successful Sales"

A Kiev-based association of fruit and vegetable retailers and wholesalers asked the Dnipropetrovsk business center to train its personnel in sales techniques. In response, International Finance Corporation/Kiev, in conjunction with the marketing specialists at the Vinnytsia Consulting Center (VCC) and the Dnipropetrovsk center, developed a sales training program for the association called "Methods of Successful Sales." (The VCC's marketing manager spent one month in the development of the seminar and estimated that her colleague in Dnipropetrovsk spent the same amount of time.) The seminar was tested in Kiev during the summer of 1998 at a discounted price. This year, the VCC anticipates profitably conducting this training for 40 or more people.

Box 2: Participating in the Risk of Financing

The L'viv BSC Consulting Department has developed a comparative advantage in the preparation of business plans for financing by establishing relationships with most of the funding institutions and banks in the region (conveniently, two investment funds and a bank rent space from the BSC). Not only does the BSC screen the applicants before submitting loan applications to the various financial institutions, but it also shares the risk of financing with the client. The BSC takes 50 percent of the cost of the consulting services up front and the balance upon the client's receipt of the loan. Of the 30 applicants for funding so far, 70 percent received loans.

underdeveloped.²³ Compounding the situation are the BSC staff's need for additional training in market research techniques and the centers' difficulty in competing with specialized, commercial service providers. The BSCs are also developing services for advertising and promotion strategies. Here again, they are experiencing stiff competition from commercial providers with highly specialized databases.

ADE and the VCC are experimenting with new consulting products. ADE developed a new product by happenstance and has been able to draw clients by word of mouth. Box 3 illustrates a serendipitous push of a new product, tender services, that seems to have worked. The VCC, meanwhile, has started to experiment with a monthly retainer ("subscription") of 100 UAH (approximately \$50 at the time the rate was established) for long-term clients in order to even out revenue flow. The services provided under the retainer are low-end services that include negotiations and/or correspondence with foreign companies and information on new laws that might affect the client. Higher-end services would be negotiated separately. To date, the center has three such subscribers.

The VCC experiment with a monthly retainer is one way of trying to provide "integrated" (bundled) services to clients. Staff members at each of the BSCs expressed to interviewers a desire to provide more than one service to paying clients, in order to increase the center's income.

Business Information

The primary function of BSC business information departments is to assist clients with foreign partner searches. Where available, the BSCs have become members of implementer- or donor-established databases maintained in a Western country (such as ADE's membership in the Bureau de Rapprochements des Entreprises, based in Brussels, with more than 800 members in 70 countries). In addition to these international linkages, information gathered from other databases and the Internet is made available to clients.

Box 3: Tender Services

The Agency for the Development of Enterprise (ADE) conducted its first market survey following a summer retreat at which staff discussed the change in program goals from small and medium-sized enterprise development to financial sustainability with the arrival of a new implementer (the third). Results of the survey indicated that business planning services would not generate much income because financing was limited, but potential clients were interested in information on and assistance with equipment leasing. ADE staff concluded that they did not know how to provide this service, even though they knew that some business service centers and incubators were doing so. However, clients were coming in based on word-of-mouth advertising about information on a new tender process. The team leader for business consulting had attended a meeting on instituting a tender process for procurement by the City of Kiev, learned how to prepare the appropriate applications, and offered it as a service to one of his clients. To date, tender services account for 73 percent of the revenues generated by ADE's Consulting Department.

²³ At this point, most of the clients for market research are foreign companies looking to enter Ukraine or to expand their operations in other regions of Ukraine.

Partner search services are not profitable for any of the BSCs studied in Ukraine, as few Ukrainian MSMEs are willing to pay for such information, and database creation and maintenance are expensive. ADE offers support services to foreign companies seeking partners in Ukraine for \$100 per day plus direct costs, but staff have found that most companies do not want to pay a fixed price for services; they are looking to pay only commissions for successful matches. “Search of Partner” has consistently generated the greatest number of inquiries for ADE since the program’s inception, but it does not generate enough money to be sustainable. (According to the manager of the International Links Department, the department is very busy communicating with companies that are unwilling to pay for services.²⁴)

The L’viv BSC provides another form of business information in serving a niche market: the center maintains databases on public companies and privatized real estate in the region for municipal government agencies.

Summary of Findings

In a transitional economy with no history of private enterprise, a supply push strategy may be needed to test the market for service interests. **Initial service offerings will change—the key is to test demand at the least cost and continually innovate to meet changing service needs as experience with and knowledge of the market grows.** Anecdotal evidence suggests that clients want tangible services they can use immediately, such as computer training, sales training for staff, and business plans for financing. The BSCs have learned by trial and error the training courses and consulting services for which clients are willing to pay—courses that were successfully piloted in one market did not attract any takers in others. The BSCs are also developing new services, both on demand, as in the case of sales training for wholesalers and retailers, and on an ad hoc basis, as in the case of ADE’s tender services. Yet even as the BSCs have changed the emphasis within service categories and added new services, they have shown a reluctance to eliminate services before donor funding ends or implementers change the conditions of assistance.

Each BSC strives to be a one-stop shop for all potential clients in its market, leading to an inherent conflict of interest between donor objectives and commercial realities. More important, BSC staff believe that as an integrated service provider, the center must offer *all* services, which dilutes its focus on core competencies and its competitiveness in the marketplace against specialized commercial providers. **Business centers need flexibility from donors and implementers to experiment with methods of better serving the MSME sector.**

Client-needs assessments in a market-creation context are very difficult to conduct, not only because the services are new, but also because the markets are small. It is not enough to learn about client interest in future services without also gaining some estimate of their willingness

²⁴ Interview with Alexander Semenov, International Links Department manager, ADE, September 22, 1998, Kiev.

to pay for such services at a price at which the BSCs can deliver. Two options for implementers and BSCs to consider in conducting needs assessments are:

- **Market and price testing.** Implementers can roll out specific services and offer them at different price points to determine interest and willingness to pay.
- **Market research.** Implementers and BSCs can research what similar types of products MSMEs currently pay for (such as alternatives to fee-based training like training videos, manuals, and overseas training).

Client demand may also need to be stimulated, through nonbusiness-center-based interventions such as education and promotion (e.g., vouchers).

In establishing services, BSCs have formed few strategic alliances with other service providers. One of the few examples is when the VCC formed a small referral network with several of its clients, including a lawyer, who received information on new legislation in exchange for referring his clients to the VCC. According to the BSC staff, **informal networks—or word of mouth—are the most effective means of promoting and marketing BSC services in Ukraine.** In a market-creation context, where implementers are looking at starting local institutions, it is important to develop institutional roots in the community and leverage other resources with a BSC's own limited resources.

Implementing agencies have tried to establish formal networks of their BSCs for the purposes of joint product development and marketing (in this way, the costs of product development are shared, complementary skills brought together, and marketing coverage enhanced). (See Box 1, above, for an illustration of a joint-product-development pilot project.) IFC and ADE are each working to expand their number of BSCs and formalize their network. Although informal networking is a key to doing business in Ukraine, formal networks are not yet part of the local business scene, partly because of the disabling business environment described in Chapters One and Two. Therefore, formal networks of BSCs are a promising Western practice for which results cannot be reported at this time.

Market Development

The DAI NewBizNet Project's initial strategy for its BSCs was to strengthen existing service provision and increase the flow of services to a new MSME market. However, DAI also introduced new services (training and business information networks) that were to be delivered to new clients as well as old, placing a heavy burden on the centers to compete effectively in all three core service areas.

Some of the advantages and disadvantages of working with an existing institution are enumerated in the "Start-up of Programs" section above. Other advantages include informal networks and business affiliations that already exist. For example, a clear advantage the L'viv BSC enjoys by virtue of its founding member is its affiliation with the L'viv Institute of Management, from which it draws most of its part-time consultants and trainers. The L'viv BSC's director is also actively involved in forging alliances with regional and city

government and business leaders in order to champion MSME development in western Ukraine. He has been able to use these connections to acquire prime office space, part of which is rented for additional income, and to participate in regional economic development programs funded by donor organizations. The L'viv BSC is also part of the NewBizNet network, but the BSC has not taken full advantage of it. The BSC's director says more could be done to develop the network.²⁵

A disadvantage of working with an existing institution is that implementers may not get the buy-in of the BSCs to serve new MSME clients over time. According to the director of the L'viv BSC, the BSC will undertake “everything that is profitable.” Although the BSC “should work with MSMEs, not banks and insurance companies, the banks and insurance companies are the ones that pay, so the BSC works with them.” Similarly, mid-sized and large companies are good consulting clients for the BSC. Indeed, the BSC believes that if it did not work with them, its competitors would take the clients.

The center's director also does not believe in subsidizing MSME clients with fees generated from larger clients. The BSC discontinued training programs for business start-ups (such as “Business Planning for Start-Ups” and “Management of New Business”) because the local employment center, which had contracted for the services, only covered 70 percent of the cost of the courses. The courses would be offered again if the BSC were to receive sponsorship of an additional 30 to 40 percent.²⁶

The L'viv BSC is seeking additional donor funding to work in the MSME sector. (The BSC currently has two training programs sponsored by grants, one for unemployed youth and another for businesswomen, and several other contracts from various donors, including USAID, EU TACIS, and the German Government.) However, donor subsidies may mask the true value of serving this market. By lowering operating costs, subsidies can distort market prices and send signals of future demand that may not exist when the subsidies are reduced and prices increased.

The L'viv BSC experience shows that there exist some training services for which MSMEs will pay “full” price (cost plus 10- to 20-percent profit). Examples include the computer-based training and sales techniques courses. For the most part, however, services targeted to certain segments of the market have been completely or heavily subsidized.

Market Facilitation

Commercial business service providers have taken a different approach than BSCs to service mix. Most have specialized in and continue to provide just **one service** (market research, business planning, or training) **for specific target clients**. One company, Kiev Management Konsult (KMK), has considerably expanded its range of services since its inception but has created specialized subsidiaries for each of the services. Box 4 briefly describes KMK. Because the company lacks the resources to develop all its new products internally, it has

²⁵ Interview with Valery Piatak, director, L'viv BSC, September 15, 1998, L'viv.

²⁶ Ibid.

affiliated with Western firms in each of its areas of specialization. KMK has also developed expertise in project management of donor-funded business development programs (currently 50 percent of its business), putting the company in direct competition with the donor-funded BSCs. Clearly, commercial service firms are responding to the donor market need for services in the MSME sector.

Donors and implementing organizations (such as EU TACIS and the Eurasia Foundation) have been able to identify service gaps and the institutions best suited to provide appropriate services, perhaps working with multiple service providers, to increase the flow of services to target markets.

CLIENT FOCUS

The BDSP client base can be broken down as follows, roughly in descending order of ability to pay:

- Subsidiaries of foreign companies,
- Joint-venture companies,
- Large Ukrainian companies (those to be privatized, currently privatizing, and already privatized),
- Ukrainian MSMEs,
- Emerging entrepreneurs,
- Individuals seeking skills training, and
- Disadvantaged or target groups, such as the unemployed, youths, former military officers, female entrepreneurs, and the like.

Box 4: The Restructuring of a Commercial Business Service Provider

Kiev Management Konsult (KMK) was started in 1994 by five participants in a training-of-trainer program in management consulting funded by EU TACIS from 1992 to 1994. KMK began by providing training services for staff of Western companies that were opening offices in Ukraine. After an initial period of growth (revenues have grown by 50 to 100 percent each year) and expansion of services, KMK restructured to form four specialized companies to provide training, consulting, project management (of donor-funded programs), and recruiting services. (KMK Group has a total of 17 full-time employees and a roster of 30 freelance consultants.) Each company is affiliated with a Western company in the same field on an agency or membership basis or as a licensee of products. Management would like to add a fifth company to provide advertising services for personnel recruitment.

KMK Group's clients are primarily Western companies (market research and recruiting clients are exclusively foreign), but KMK does serve the Ukrainian small and medium-sized enterprise (SME) sector (30 to 40 percent of its revenues are generated from SMEs). A significant portion (50 percent) of KMK's business is now project management. KMK has been a subcontractor to organizations working with both multi- and bilateral funding organizations but has recently been awarded direct contracts by EU TACIS and the Academy for Educational Development (a USAID-funded training organization). KMK's restructuring may be as much a response to a hostile business environment as it is indicative of changes in the Kiev market, which rewards more specialized providers. The key point here is that as the market evolves, the business models that best serve it will change from a one-stop service model to a model in which service providers are more specialized by market and/or product.

Market Creation

Agency for the Development of Enterprise

In 1994-1995, ADE started out by serving individuals and MSMEs with free or low-cost basic business information and training services.²⁷ In the first few years, ADE served up to 1,400 clients a year. Recently, the number of clients has been reduced (ADE was unable to supply the research team with appropriate numbers for the current year because its database had not been updated) and the nature of certain services changed. The Training Department's activities are now focused primarily on tailored training for MSMEs with up to 10 retail outlets, and the Consulting Department has added tender services in addition to business planning. ADE's International Links Department (information department) continues to offer most of the same services (partnership searches for Ukrainian MSMEs, publication of a business opportunities bulletin based on data from the Bureau de Rapprochements des Entreprises database) and continues to serve the MSME market—70 percent of its clients are small companies.²⁸

With a change in emphasis in mid-1997 from service provision to sustainability, ADE staff have developed a marketing plan to target fee-paying customers—European companies (with assistance from the expatriate advisor), government agencies, joint-venture companies, and “successful” Ukrainian companies. Even so, ADE does not believe that income from fee-paying clients will be able to subsidize services to the MSME sector. ADE staff have determined that 60 percent of the organization's activities must be supported by donor subsidies or task orders.

The Vinnytsia Consulting Center

The VCC served approximately 550 clients from May 1997 to August 1998. The research team was unable to gather adequate information on the size of the client companies from the database information provided (approximately 170 companies registered in the VCC's database have received one or more of the center's services). Nonetheless, anecdotal evidence suggests that more than 66 percent of the VCC's income in the latest six months of operation ending August 31, 1998, was from large clients and other donor-funded organizations. The same figure for May 1997 to August 1998 to date is approximately 43 percent, indicating that the VCC has moved to providing more services to large companies. (The center's primary consulting client is a large manufacturing company.)

Both ADE and the VCC have made a rational shift to seeking fee-paying clients. This has meant an effort to provide more “complex” (bundled) services and an attendant move to

²⁷ At that time, EU TACIS set up two other projects: the Project Preparation Unit, which would do business plans, and the Business Communication Center, which was set up at the Ukrainian Chamber of Commerce.

²⁸ Interview with Alexander Semenov, International Links Department manager, ADE, September 22, 1998, Kiev.

acquire foreign and larger Ukrainian clients. Early suspicions that commercialization would tend to limit services to the MSME sector have been confirmed by the actions of the BSCs. The BSCs have not yet developed a balanced client mix of those who can pay now and others who can possibly pay in the future. It is very difficult to create a special-focus institution (e.g., MSMEs) while trying to achieve commercial goals (through revenues from MSMEs).

Market Development

The experience of the L'viv BSC illustrates that a strategy of client diversification can increase the flow of services to the MSME sector. Initially, the L'viv BSC served large clients undergoing privatization and restructuring. With donor input, the BSC began serving MSMEs. For the period from October 1997 to June 1998, 57 percent of the BSC's clients were MSMEs. It is difficult to determine, however, whether the L'viv BSC will continue to serve the MSME sector without donor subsidies.²⁹

Market Facilitation

Existing commercial service providers in Kiev and L'viv first targeted Western companies entering Ukraine, then large Ukrainian companies as market demand among that population grew, and, finally, the expanding MSME sector. As the commercial BDSPs have gained the attention of donor-funded MSME support programs, they have been contracted to provide services to segments of the MSME and disadvantaged populations, including youths, unemployed miners, former military officers, women, and emerging entrepreneurs, among others. Donors that intervene in the market as clients, however, need to recognize their role as clients and understand the better principles by which public-sector contracting operates. Donors can also work through the demand side with direct subsidies to MSMEs, perhaps in the form of vouchers for services.

FINANCIAL VIABILITY

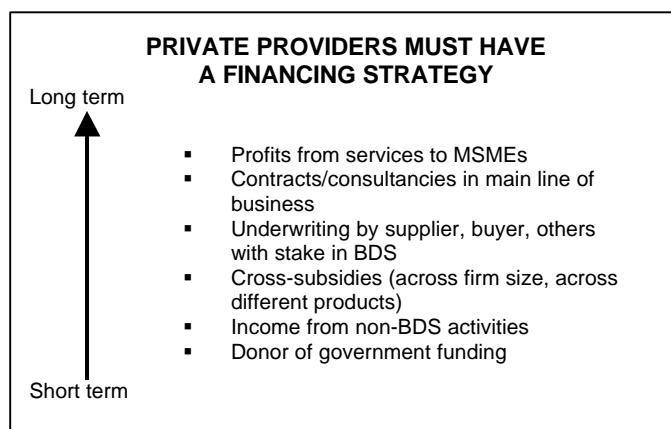
It is extremely difficult to determine financial viability for the donor-supported BSCs by relying on Western standards of measurement. Local business practices, such as nonreporting of cash income and inflation of expenses to reduce tax payments, conflict with Western ideals of sound practices. Certain pieces of financial information are closely held "commercial secrets" and are not revealed even to the implementing organizations that provide subsidies. Therefore, given the time constraints and reliability of the information collected for this study, no definitive analysis of financial viability was conducted, nor is one presented in this report. Instead, the concluding chapter of this report discusses several core

²⁹ As of December 1998, direct subsidies to the L'viv BSC were removed. However, for specific services, a new task order-based contracting system was established so that MSME could continue to receive services at varying rates of subsidy during a limited period. Each task order relates to a specific service, targeting a specific client over a specific time. (In fact, the Director of the L'viv BSC would prefer this mechanism over direct subsidy in order to maximize the money spent on clients.)

issues related to business center viability, specifically (1) the need for low-cost management-information systems that can serve both donor and business center interests; (2) the role of donors as clients of business centers in transitional economies, and their use of subsidies and incentives to develop (versus distort) the market for business development services; and (3) the issue of compatibility between business center financial viability and donor goals of outreach to MSME clients.

Two points are worth noting. First, it was never the expectation of donors that the centers would achieve financial viability based solely on service profits from MSMEs, especially in transitional economies, where even medium-sized and large domestic enterprises frequently fail to appreciate the value of business development services. Second, in the Ukraine market context, donors must be considered part of the client portfolio of business service providers. Figure 2, below, shows different sources of and expected changes in BSC revenue over time. Best practices with respect to financial viability would show trends away from donors as the main clients to other sources and strategies of revenue generation. What follows are the research team's observations of the current status of the financing strategies of the three business centers in this study.

Figure 2: Financing Strategy for BDS Providers



Source: "Summary Report" of the March 1999 Donor's Committee Conference on BDS, Rio de Janeiro, Brazil.

Market Creation

Agency for the Development of Enterprise

In August 1997, EDAW-TSD planned to implement several strategies to increase the cost coverage of ADE to 60 percent from earned income (it is unclear where the remaining 40 percent was to be obtained) while maintaining a focus on MSME support services. It sought to do so by taking the following steps:

- Introduce a computer-based accounting and management-information system to replace ADE's current Ukrainian accounting system;
- Develop a business and marketing plan for ADE;
- Restructure the organization into functional teams, with team leaders and financial targets; and
- Develop an incentive plan to stimulate entrepreneurship among staff members.³⁰

ADE staff members have responded to these strategies with some reluctance to adopt new systems. At the time of this research, the organization's complete financial reporting system was not yet in place, client-tracking information had not been updated for six months, and the incentive system was still being refined. ADE staff expressed a preference for a regular salary as opposed to a large bonus incentive. ADE staff also expressed a desire to continue to serve the MSME sector, determining, as noted previously, that 60 percent of their services should be covered by donor subsidies or task orders.

In the past, services targeted to micro- and small enterprises, would-be entrepreneurs, and disadvantaged populations were performed with funding from the governments of Italy and the Netherlands, other EU TACIS programs, the Eurasia and Renaissance (Soros) Foundations, and the British Know How Fund (BKHF). Currently, the only targeted program left, Basic Business Information for emerging entrepreneurs, was scheduled to be integrated into ADE's operations after funding from the Italian Government was to end in December 1998. Besides a Eurasia Foundation grant for the publication of a guide to small and medium-sized enterprise programs in Ukraine and rent from another TACIS program housed in its offices, ADE has no other sources of income other than operational subsidies from EU TACIS and fees generated from service provision.

ADE faces an additional problem in trying to increase its cost coverage—the legacy of free services. Clients do not want to pay for services, because they know ADE is funded by EU TACIS; hence, they do not perceive ADE as a commercial service provider. Current donor and implementer efforts to move the BSC toward commercialization and self-sustainability conflict with the original goals of business service delivery to MSMEs.

The Vinnytsia Consulting Center

The VCC has always maintained financial viability as one of its goals. However, with little more than six months before subsidies were scheduled to end, the center was only covering 32 percent of its expenses. Start-up and registration of the company took one of the two years it was given to achieve self-sufficiency. (A lesson learned from this experience is to have BSCs registered as legal entities prior to their opening for business.) At the time of this study, the VCC did not have a business plan from which it was working. Additionally, the director's time was being split between coordinating activities for both the VCC and the ADE branch in Vinnytsia.

³⁰ "EDAW-TSD Project Synopsis," unpublished, 1997.

Summary of Findings

The focus on institutional development based on a Western understanding of an acceptable professional service office has resulted in high overhead costs that are difficult to maintain after the subsidy ends. Additionally, **subsidies based on operating expenses have built-in donor dependence.** For these and other reasons, progress toward financial viability has been slow. BSCs are trained to respond to donors rather than clients for market signals. Rather than seek to cross-subsidize MSME programs with income generated by fees, BSCs have looked to substitute one donor for another or receive funding from multiple donors. (In Ukraine, the Eurasia and Renaissance (Soros) Foundations have contracted for services from the BSCs through grants, while USAID, BKHF, EU TACIS, and programs funded by the Italian, German, and Canadian Governments have all supported the creation and development of BSCs.) In particular, ADE and the VCC seek continued donor support for their activities.

Market Development

In contrast to ADE and the VCC, the L'viv BSC provides an example of the advantages of building on local suppliers to serve MSME clients. The L'viv BSC has been able to use its network to expand downmarket easily, which has resulted in greater revenue growth. Revenues more than doubled from fiscal year (September) 1996 to 1997 and grew by 50 percent in fiscal year 1998. The L'viv center, true to its original premise, was able to build on its leadership, existing networks, skills, and institutional base to serve MSMEs with services. Yet this approach has had its costs and risks. For example, the L'viv BSC's experience shows that an existing, sustainable institution can become donor-dependent for a period of time because of implementer-mandated services and practices. These practices have required a doubling of systems (financial management and reporting, client tracking) on top of local practices and networks. In addition, the incentives and subsidies used may have masked the services' commercial value for both clients and providers. In response, **implementers may prefer to subsidize variable costs of increased service flow as opposed to fixed costs such as rent, salaries, and equipment as a more effective and efficient way to develop a market.**

Market Facilitation

Sustainability of services rather than of institutions is at issue in market facilitation.

Donors and implementers can assess the effectiveness and efficiency of existing service providers and encourage new entrants to facilitate service flow. It is clear from the research that new entrants are selling services and that the range of services for MSMEs is growing. Service gaps for MSMEs still persist, but substantial facilitation by donors indicates that services to this sector will be sustainable.

CHAPTER FIVE

LESSONS ON COMMERCIALIZATION AND ISSUES AND CHALLENGES FOR MSME BUSINESS DEVELOPMENT SERVICES

LESSONS ON COMMERCIALIZATION OF BUSINESS SERVICE CENTERS

Despite the limits of the research design, as outlined in the first chapter of this report, several lessons were learned from BSC program start-up, service, and client mix that might be useful to donors, BDS facilitators, and business service suppliers.

Start-Up and Entry Orientation

Common Vision among Stakeholders

The VCC and the L'viv BSC were established with the goal of financial viability and were registered as for-profit companies. The L'viv BSC is the only BSC in the study that maintains a business and marketing plan to reach sustainability by the time donor support is scheduled to end. ADE was established as a business development agency with a nonprofit orientation, and financial viability was not a concern until 1997. As a result, shareholders are reported to have lost commercial interest in the organization, while staff are not interested in the commercialization of all services.

Donors, implementers, and BSC shareholders and staff must agree on a realistic set of objectives for their programs in order to balance the tension between public goals and the goals of BSC sustainability. Financial viability must be built in from project inception in order to influence BSC activities as well as staff mindsets. There must be a structured plan for the BSCs to reach self-sufficiency within an acceptable time frame, with rolling annual and longer-term business planning as key indicators of good business practices. Donors should establish clear targets for achieving public goals and rewards for achieving those targets.

Market-Driven Approach to the Location of Centers

EU TACIS entered the Vinnytsia market (an agriculture-based town with a population of approximately 375,000 located about four hours from Kiev) in mid-1998 by opening a full-service branch office of ADE. (The VCC was already established there as a full-service BSC.) The stakeholders of the VCC and ADE made a decision to try to combine forces so that the organizations would complement rather than compete with each other. It is too early to judge the success of this partnership.

Thorough research should be done to see if the location can support the sales of both basic and value-added services to the target market.

Active Stakeholders with Business and Government

The Business Service Center represents a support entity to businesses and is directly linked to the overall well-being of the business environment. If the business environment is constrained by legal and regulatory issues, it is in the interest of the BSC to participate in a policy dialogue with the appropriate government agency to remove those constraints. This is of particular importance in the Ukraine where regulatory constraints—such as licensing, inspection, and oversight—can take up 50 percent of a manager's time.

Dedicated and Dynamic Managers

ADE's director is well connected at the national and regional levels in the sphere of MSME development in Ukraine. As former vice president of the Ukrainian League of Industrialists and Entrepreneurs, she is a leader in the business community in Kiev. She has recently reorganized the ADE into service divisions, giving senior staff more responsibility for management and business development.

The director of the L'viv BSC is extremely active in business development both locally and regionally. He is a LIM board member and serves on several MSME development committees at the city and oblast administration levels. Most of the responsibility for managing the BSC rests with its division managers.

Good leadership and management are essential to the success of the BSCs. BSC directors must be carefully selected for entrepreneurial spirit and should be well trained in managerial and technical skills. Competent local staff must be involved in the planning and development of the BSCs from the very beginning, otherwise leadership, management, and skills transfer from Western advisors and consultants to local managers will be more difficult to achieve.

Service and Client Mix

Selling What the Market Wants

Ukrainian businesses want tangible services they can use immediately. Toward this end, the BSCs in this study have shown some promise in providing services such as training in computers and accounting. The L'viv BSC has demonstrated particular success in being able to match its clients' needs for credit facilitation with access to loans. However, at the same time, they have built features into products (at a high cost) that businesses need but do not presently value. Business plans are a good example: this product could be either a tool for

securing financing or a skills-based training product that could be both a financing and a management tool. Currently, entrepreneurs value only the former aspect.

Each product contains different features, benefits, and costs to the customer. In Ukraine, it will take some time to develop a market for products that clients (as opposed to donors and implementers) do not value presently but could in the future, with more knowledge of the benefits of “capacity-building” products.

Commercial Viability and Client Focus

When the market drives service mix and client focus, BSCs have gravitated toward serving those clients who can pay. Indeed, the goal of commercial viability requires that providers have the flexibility to respond to their market. After all, every business has a diversified client base from which to draw revenues; “cash cows” or favored clients; and new clients who could become favored clients.

The right client mix must be one that looks toward the future but understands the realities of today. The research team identified some promising practices in this regard: bundling of services (“complex” services) for good, paying clients; specializing in specific services for a specific client segment (such as tailored training for wholesale and retail clients); and sharing financing risks with clients (such as L’viv’s “success” fee for credit facilitation).

Informal Networks to Leverage Resources

Informal networks have proved to be the most effective means of BSC marketing and promotion through word-of-mouth client referrals. Implementers have promoted more formal BSC networks with varying levels of success. Commercial service providers have established linkages with international companies to increase their offerings of service products.

ISSUES AND CHALLENGES FOR MSME BUSINESS DEVELOPMENT SERVICES

This report ends by addressing some of the core issues and challenges associated with meeting MSMEs’ BDS needs using commercial approaches in transitional economies. As noted in Chapter One, these include the following:

- How to reconcile Western business practices with local methods, customs, and practices;
- How to reconcile the often competing goals of service outreach to MSMEs and service sustainability through financially viable business service centers; and
- How to intervene with the right mix of subsidies and incentives to strengthen rather than distort market signals for MSME support services.

Good Practices for BSC Commercialization

A basic, yet key, lesson from this research is the difficulty and elusiveness of trying to understand sound practices of BDS commercialization in environments where business regulations and laws are not enabling. The major focus of the research design was to learn about the practices used by the centers in becoming more demand driven and commercially oriented in their operations. Each implementing agency assumed that Western systems (generally accepted accounting principles, client-tracking systems) and practices (transparency, staff incentives) would strengthen the commercial operations of the centers and thereby accelerate service access to the MSME sector. Yet, the research team found that the systems, although designed and implemented, with staffed trained in their use, were not being routinely used by BSC managers to guide business decisions. In Ukraine, where the regulatory environment is overly burdensome, with high taxes and multiple licensing requirements, businesses will hide revenues, increase expenses, and take steps to reduce the number of inspections. This puts the business centers in a position where implementing suggested Western business practices may be at odds with what they see as their best strategy for surviving in a hostile business environment. A major reason the installed systems did not appear to be used, then, was to avoid auditable indicators of success—such as increases in revenues—that tax collectors could use to impose tax burdens.

The hostile environment undermines activities designed to monitor and evaluate business center performance and its impact on MSMEs. There appears to be a tradeoff between flexible information management required by commercially oriented business service providers and the requirement of donors for accurate and reliable operations data to monitor BSC performance and the impact of their investments in the centers. For example, the research team found it very difficult to gather trend data on revenue and costs, or services delivered and clients served, as records either were not formally kept or served the BSCs' needs to report to tax collectors or regulators.

These problems present donors with a dilemma in promoting good business practices: in the short term, flexible management systems may be required as business center managers pursue commercial goals in a hostile environment. Over time, however, donors should actively pursue policy changes that would make Western business practices and tools the choice of MSMEs and business centers. This would enable BSCs and their clients to take advantage of the efficiency of such practices without their previously problematic costs.

Currently, it may be difficult to use financial sustainability as an indicator of good practices in BSC performance and impact because of the lack of reliable data on revenue and costs and their allocation to different services and clients. Instead, donor-supported programs could track indicators at the BDS-market level: volume and flow of services to MSMEs and the sector dynamics of both MSME clients and BDS providers (births, deaths, survivors, and growers). This would, however, require different survey methods and tools.

Client Outreach and Business Center Financial Viability

There are indications in the three centers studied that a trade-off exists between outreach to MSME clients and the financial sustainability of the centers. All three centers currently target MSME clients with a mix of services, but will they continue to do so in the future when donor subsidies are removed? Similarly, if the centers continue to serve MSMEs, will they offer the volume of services needed to benefit the MSME sector?

The research team studied the BSC databases to examine this possible trade-off. By tracking revenue by size of clients, the team hoped to determine whether the client mix changed as revenues increased. Also, by tracking revenues by service and client size, the team wanted to learn whether there was a connection between services in greater demand by MSMEs and their returns to service providers. As reported above, the necessary data were not consistently available at the centers to examine this trade-off. However, the most convincing indicator of this trade-off's existence is simply the strong conviction by center managers and staff that the trade-off is real. ADE's manager specifically stated that the organization can only cover 40 percent of its operating costs from the sale of services to MSMEs. This conviction by business center managers will lead them to target larger clients and reduce outreach to MSMEs unless convinced otherwise with strong evidence that serving MSMEs contributes to their commercial goals.

Evidence of donor-supported business center programs elsewhere in the ENI region clearly points to the very real trade-off between business center viability and a focus on MSME clients. A recent case study on three Romanian business centers examined changes in their revenue structures over the three-year period of donor support (1994-1997).³¹ The study found that after donor funding ended, each of the three centers continued to operate but with a diminished focus on MSMEs and an expanded focus on large businesses and project management for donors in service areas unrelated to MSME development. Similarly, a recent case study on USAID's business development program in Russia examined the implications for service mix and client focus when business centers transformed themselves from donor-supported to self-sustaining entities. The study found that the "spread of services narrowed, and the number of client target groups and the diversity of clients decreased."³²

Both reports also point out that when sustainability was mandated by donors, there was no expectation that the business centers would be able to achieve financial viability by fees from the sale of services to MSMEs alone. Each of the centers has pursued a somewhat different strategy for sustainability, depending on its market, its core capacity, and its ability to secure tenders from donors and public-sector agencies.

Clearly, the drive for financial sustainability will alter the service mix and client focus of business service providers—after all, financial health will depend upon success in generating

³¹ "Case Study on the Operation of Three Romanian Business Centres," by R. Kennedy, P. Scholtes, and C. Sonnesson, UNDP, March 1999.

³² "Business Development in Russia: New Business Development Program," by I. Astrakhan, C. Stinger, and Y. Yanboukhtina, World Bank, March 1999. For this paper and that in the preceding footnote, visit <http://www.ilo.org/public/english/65entrep/iseip/bds/donor/rio.htm>.

fees, contracts, and grants from those who can pay. The Romanian study suggests that changes in business center revenue structures have not caused a major change in the original mission of the centers, because of the strength of the missions and the centers' strong governance. However, the report acknowledges that financial imperatives could cause the mission to creep away from its original intent: "Given the recent growth in income from project contract work, it will be interesting to see how the mission changes in the next few years."

Again, indications in Ukraine and evidence elsewhere clearly underscore the trade-off between BSC financial viability and client outreach. Donors should carefully monitor changes in revenue sources and amounts over time, as they may foretell changes in mission away from the MSME sector. The trade-off trend does not necessarily mean that BSC missions will change; strong leadership and governance can maintain a BSC presence in MSME development. The question is whether core competencies are spread and diluted among non-MSME services and whether the BSCs' reduced role and involvement in the MSME sector render them unable to address the sector's expanding needs. Again, donors' desire to track these changes requires systems that may put their information needs in conflict with those of commercially minded business centers. The adoption of core indicators and low-cost data collection systems that can serve both donors and business centers remains an unresolved issue that must be addressed.

Subsidies and Their Use to Build BDS Markets Serving MSMEs

The choice of whether to use donor subsidies and incentives should be dictated by market context. In studying the attempts of this study's three donor-supported business service centers to reach sustainability, the research team found that the BDS market, particularly in the larger regional centers, is relatively broad and dynamic compared with the initial perceptions of the implementers. The team also found that a range of new entrants—private companies, sole proprietors, educational institutions—has entered the BDS market and is serving MSMEs with donor support. Consultants and trainers who had been trained by donor-funded programs started their own companies once they realized that consulting could constitute a business, leading to the indigenous development of commercial business service providers. (Training under a donor-funded program lends legitimacy to those consultants and trainers who have no previous experience or track record in BDS.) In all cases the team observed, the commercial consultants in question were young (under 35), newly educated people. Some of the companies created by former trainees and consultants have survived now for almost five years and are providing training to staff of newly established donor-funded BSCs.

The active presence of indigenous service providers in some of the markets of the BSCs studied raises the following questions: What are the characteristics of the BDS market, and how do they influence the choice of implementation methods in MSME support? What combination of demand- and supply-oriented instruments (such as promotion, training, vouchers, and institutional strengthening) would be appropriate for different market settings?

The market framework—used as a tool by the research team to better understand the experience of the centers—may be helpful to donors and implementers in designing strategies that support the MSME sector in developing and emerging markets. Recommendations for donors and implementers in the use of the framework are listed below.

- **Conduct good diagnostic work**, such as a detailed subsector-based assessment of the depth and breadth of the market, before deciding on intervention strategies for BDS. Determine the service providers that already exist or could enter the market to serve MSMEs.
- **Use a stepped approach** to the provision of BDS by filling service gaps with the most cost-effective methodology first. The choice of strategic interventions—to encourage demand, encourage more targeted supply, or some combination of both—should be consistent with the market context.
- It is difficult for any one service provider to build a service market where none or only a weak one exists. Therefore, donors might **stimulate demand for services** using public relations campaigns (for example, “entrepreneur of the year”) or redeemable payment vouchers, which put subsidies in the hands of the consumers.³³ Donors could help consumers make choices by promoting services and their value and/or promoting providers and their track records. Donors could also build the supply side of the market, as happened in Ukraine, by training consultants or making them aware of consulting as a business opportunity. These interventions might serve as substitutes for institutional strengthening models or as strategic complements to lower the costs of staffing and/or promoting BSC operations. Additionally, donors might consider setting up a temporary clearinghouse to build both demand (public relations, vouchers) and supply (consultant training, exchange visits).
- **Institutional development strategies need not be abandoned, but donors should not automatically pursue them without first assessing other market-based interventions designed to meet the goal of sustainable service access to MSMEs.** When institutional strengthening is preferred, two strategic options appear to be consistent with the commercialization process:
 - a) Market leaders may facilitate BDS markets as their internal investments (such as staffing, product testing, and promotion) and their pursuit of commercial goals stimulate new entrants. The strategy is resource intensive but may facilitate the growth of BDS markets with new services, new partners, and/or new competitors. The risks to commercial viability are also high: high costs and more competition.

³³ Pertinent research on the use of vouchers is presented in two case studies: “The Voucher Training Model: What Next, after Paraguay?” by Lara Goldmark, IADB, and “Kenya Voucher Program for Training and BDS,” by Thyra A. Riley and William F. Steel, World Bank. See the ILO Web site at <http://www.ilo.org/public/english/65entrep/ise/bds/donor/rio.htm>.

- b) Niche marketers are the second business model that may succeed in satisfying policy goals with a commercially viable entity. The lesson from commercial providers is that they create separate entities to exploit niche markets defined by specialized products or services. Their cost structures are relatively low, their skills are tailored to their service mix, and the rise and fall of their companies are determined by how effectively they compete in price and quality in their markets.
- **Use a mix of supply- and demand-led incentives and subsidies that are consistent with the overall objective of the program.** The research team found that there was not a good match between the subsidies/incentives used and the overall goal of increasing the flow of services to the MSME sector. Blanket subsidies that were tied to expenses appeared to set up the wrong incentives for commercialization: they encouraged increased costs instead of cost containment and encouraged managers to take their signals more from donors than from the market. Subsidies need to be consistent with desired changes, structured so that they reward performance, and monitored so that the appropriate sanctions can be applied. In Ukraine and other markets where the environment does not enable business, the process of finding the right incentives will need to be continually reviewed and refined. Some subsidies/incentives that seem to match the goals of commercialization are the following:
 - a) Supply-led incentives for providers, such as task orders priced by service. (IFC instituted task orders for the VCC, but the payments were based on a stepped-down subsidy schedule for expenses rather than on the services provided.) Public tendering, while a better donor practice to build supply, has potential downsides: it can encourage specialization of suppliers as providers of services to public-sector entities and not directly to MSME clients; discourage the learning associated with being market responsive; and distort prices, which would be set by donors rather than the market.
 - b) Demand-led incentives that create capacity within a provider organization (e.g., training and exchange visits) and build knowledge more broadly within the marketplace (e.g., public relations campaigns).

ANNEX I

MBP PUBLICATIONS SERIES

